

OEICs, Unit Trusts and ETF's

OEICs and Unit Trusts are forms of collective investment, which allow individuals to participate in a large portfolio of quoted securities by pooling their money together with other investors. This gives the individual access to a much wider spread of holdings than can normally be achieved with smaller sums of money, which in turn reduces the risk. The fund is divided into units or shares, which are valued on a daily basis and reflect the underlying value of the fund. This value will fluctuate on a daily basis with market conditions.

Basically, OEICs and Unit Trusts are a flexible and relatively cheap way to invest in the stock market. They are run and regulated in a similar way, and you can hold them within an ISA. There are differences (an OEIC is set up as a company whereas a unit trust is a trust) and you will usually find that unit trusts have two prices - the 'bid' price which is the lower price you receive when you sell, and the higher 'offer' price you pay to invest. The difference between the two prices is commonly known as the bid/offer spread. With an OEIC there is usually a single price to buy and sell shares, so it's easier to see the actual effect of charges. However, unit trusts are expected to become 'single-priced' eventually, with some already so. It is therefore important that you understand the way your investment charges are made - the Key Features document explains this.

It can cost fund managers less to run an OEIC than a Unit Trust, so some companies reduced their initial charges when they converted their unit trusts to OEICs, although annual charges remain much the same.

Another advantage of OEICs is that it may be cheaper to switch between a manager's different funds than between unit trusts because of the OEIC's structure. Each may be made up of various sub-funds, and when you buy shares in an OEIC you actually invest in one or more of the sub-funds. Changing between sub-funds e.g. UK for European or vice versa, is easier than switching between completely separate unit trusts. Several OEIC managers have therefore cut switching charges or even offer free switches.

Income (the yield, dividend or interest) from these funds can be distributed or accumulated within the fund and is paid net of basic rate tax. Higher rate taxpayers will have to declare this income on their tax return and pay the difference between the tax deducted and either higher rate tax, in the case of interest, or 32.5% in the case of dividend income. Non taxpayers can no longer reclaim the tax which has been deducted at source from dividend income but they can reclaim tax deducted from income that is classed as interest, e.g. such as that payable from a fixed interest fund or a fund holding a substantial proportion of interest-bearing assets such as corporate bonds.

When the holding is surrendered, if there is a gain, this is subject to capital gains tax. However, each individual has the benefit of an annual allowance, and as long as the gain together with any other gains you may have in the same tax year is less than the allowance, there is no tax to pay. Any gain in excess of the annual allowance will be taxed at a single rate of 18%.

Exchange traded fund (ETF)

An investment fund, tracking a sector or index that is traded on a stock exchange. An ETF typically trades at a price which is very close to its net asset value, unlike an investment trust. This means that you can usually be confident that the price of an ETF very closely reflects the value of the investments it holds and sector or index it tracks.

Essentially, an ETF offers the benefits of a collective investment fund yet trades on a stock exchange like a share. Most track a specific stock market index such as the FTSE 100 or FTSE All Share.

ETFs are characterised by low costs and stock-like features. They have been available in the US since 1993. In the UK they were seen as of limited appeal until a recent advantageous change in Stamp Duty rules made them a more attractive and cost efficient method of investing in a particular index than passively managed funds.

The most widely used form of ETFs in the UK are iShares operated by Barclays Global Investors. It is important to bear in mind that iShares are domiciled in Dublin so that there is no UK tax credit, which may mean that a UK investor will incur an additional tax charge on dividends. However, ETFs can be held within a stocks and shares ISA or SIPP, thereby sheltering the dividends against tax.